RATHBONES

Weekly Digest

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Madame Butterfly

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A landslide snap-election victory for Japan's ruling party could be a catalyst for rises in the yen and Japanese bond yields. That could have negative reverberations across the globe. All the same, we remain positive on the outlook for the global economy and markets.

Quick take:

- The yen and Japan's bond yields are up on stimulus expectations.
- These moves could have negative reverberations across the globe.
- Amid these risks, continue global growth and strong corporate profits keep us positive.

Many are familiar with the concept that a very small action in one place can create a disproportionately large reaction elsewhere, a concept known as the butterfly effect. The idea is that in a chaotic, non-linear system a butterfly can flap its wings on one side of the world, setting off a chain of events that results in a tornado on the other side. What better place to apply this theory than in financial markets, where so many influences collide to produce today's prices?

Japan's LDP landslide

The 'butterfly' in this case is Prime Minister Sanae Takaichi. After election to lead Japan's ruling Liberal Democratic Party (LDP) in October, she boldly called a snap general election to confirm her mandate to pursue a more expansionary policy. Over the weekend, her gamble paid off in spades as the LDP secured a supermajority in the Lower House, strengthening its position.

Indeed, it was the best result for any single party since World War Two, although the Upper House remains divided, which might rein in Takaichi's bigger ambitions. Within Japan, the consequences are reasonably clear. It opens the door for more government stimulus and pro-growth policies. That's positive for the equity market, notably for sectors that might benefit from the need for greater self-reliance, such as defence, technology and semiconductors. This is symptomatic of the broader global shift to secure supply chains, which has recently galvanised the outperformance of more cyclical sectors.

However, the proposed ¥21.3tn ($135bn) stimulus package (the equivalent of 3.5% of GDP), has sent some jitters through

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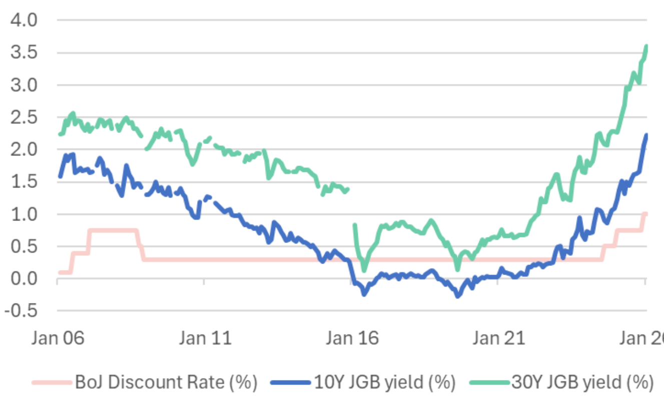
Japan's bond and currency markets. This could cause more negative effects to reverberate globally. We have other reasons for staying positive, which I'll explain later, but it's a risk we'll be keeping an eye on.

Cash and carry

Japan's low interest rates and bond yields have been a source of cheap cash for years (figure 1). Not only have domestic Japanese investors been forced to seek better returns overseas; global investors have borrowed cheaply in yen to fund purchases elsewhere (known as the 'yen carry trade'). It started out largely as an interest rate arbitrage, selling yen to buy higher yielding currencies. But latterly, this turned into outright speculation on assets like US technology stocks. It all worked beautifully as long as the yen was weakening and those assets were rising.

Figure 1: Japanese rates, yields on the rise



Sources: BoJ, Factset, Rathbones; as at 30 Jan

However, the yen has had bouts of strengthening and the more leveraged carry trades (placed using borrowed funds) had to be unwound quickly. This happened in July and August 2024 when the Bank of Japan (BoJ) delivered a hawkish policy surprise. The yen gained more than 10% in value against the dollar, forcing near-panic selling of the leading technology stocks (the Magnificent Seven fell 18% as a group).

We haven't seen anything like that since. It's quite possible that much of the speculative froth was blown off in 2024. Nobody knows the true extent of yen carry trades, but there's scope for the yen to rise from its current historically weak levels (figure 2), flushing out more of them.

Figure 2: The historically weak yen

Source: Factset, as of 10 Feb

There are also rumbles of discontent whenever the yen's exchange rate with the dollar approaches ¥160 (it was near ¥156 at the time of writing). Such a weak yen increases the risk of higher inflation in

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Japan and gets under the skin of the US government who view it as a means of dumping cheap Japanese exports on the US. Hence the recent supportive statements and veiled threats of intervention from Japanese officials. The economic fundamentals also suggest the yen is substantially undervalued. According to an IMF measure of its international buying power (what's known as purchasing power parity), its fair value is about ¥94 per dollar.

Today, there's also concern about Japan's government bonds (JGBs). From 2021, JGB yields rose as the economy's growth become sustainable and it exited three decades of deflation. Over the last two years, the BoJ has increased rates from -0.1% to 0.75%, and JGB yields have increased by even more (see figure 1 above). These yields could head even higher along with increased JGB issuance, inflation and interest rates.

The broader risk is that the impact spills over into other major bond markets. Ten-year JGB yields are now higher than 10-year German bund yields, when subtracting the cost of hedging yen into euros. For a Japanese investor, that makes it tempting to repatriate investments just when, for example, bund issuance is rising as Germany pursues its own fiscal expansion.

Bond yields are also used to discount the present value of future cash flows from other financial assets. So a rise in yields without an offsetting increase in expectations for growth or profitability (all else being equal, which it rarely is!) would reduce the value of those other assets. This could threaten the good start that stock and bond markets have both had so far this year, as I wrote about in last week's Monthly Digest.

Keeping it short

This threat of rising yields gives us another reason to shy away from bonds with longer maturities. The UK political situation also argues against having exposure to longer-dated gilts, at least if we take recent market moves at face value. Last week's Bank of England Monetary Policy Committee meeting had a much more dovish outcome than expected, with the probable date of the next base rate cut (usually good for bonds) being brought forward by a couple of months to April. Yet, longer-dated bonds sold off again in response to persistent threats to Sir Keir Starmer's leadership of the Labour Party. The market's view is that a change would take the party further to the left, with negative implications for fiscal policy (more 'tax and spend') leading to higher deficits, more gilt issuance and increased concern about the country's overall financial position.

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Positives still outweigh the negatives
As with a lot of other worrisome things going on at moment, though, none of this compels us to adopt a more defensive stance in portfolios. It's another factor on our watch list. The corporate earnings season is progressing nicely. The rotation by investors into sectors other than those that have dominated the leaderboard since ChatGPT was launched in late 2022 also shows that they are seeking – and finding – new opportunities. Many equity indices are making new all-time highs, even as some of the former tech leaders come under selling pressure.

Global GDP growth looks set to chug along at around 3% this year– somewhat below the long-run average, but far from anaemic. Current data also suggests that the threat of a sharp slowdown in the US, the most important economy for investors, is remote. Indeed, last week the ISM index on activity in the manufacturing sector jumped to its highest level since October 2022, and reached into expansion territory for the first time in a year. President Trump is also going to do everything in his power to sustain or even increase growth heading into November's mid-term elections. This also supports the rotation towards more cyclical assets and a general broadening of market returns beyond AI-related stocks.

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Regional highlights

UK. The Bank of England left its base rate unchanged at 3.75%, but the Monetary Policy Committee's 5-4 vote turned out to be much closer than expected. The statement cited "less pronounced" inflation risks and noted that rate cuts are "likely to be reduced further". However, the latter claim was already very much priced into markets – it's always been a question of when not if, and then by how much. The Bank sees inflation reaching its 2% target as soon as April thanks to energy price-cutting initiatives announced in the last Budget and the effect of big price increases a year earlier falling out of the annual calculation. It reduced its 2026 inflation forecast from 2.8% to 2.1% but also cut its GDP growth forecast from 1.2% to 0.9%. The immediate market reaction was to bring forward the timing of the next quarter-point rate cut from July to April, with a second cut priced in for December.

US. The short-lived government shutdown deprived economists and traders of monthly employment data, one of the more important regular series (it will appear on Wednesday). Other data continues to point to a continuation of a 'no-hire, no-fire' labour market, with job openings fading but no real pick-up in weekly jobless claims numbers. Instead, investors latched onto a surprisingly positive ISM survey of manufacturing activity, as noted above.

It looks as though the capex boom associated with AI is building a head of steam and that other plans – put on hold last year owing to tariff uncertainty – are being implemented.

Europe. The European Central Bank (ECB) left its deposit rate unchanged. The rate-setting council took comfort in recent solid growth data, without appearing too concerned about lower-than-expected inflation in January or the headwind to trade generated by a stronger euro. The expected boost to growth from rising public infrastructure investment and defence spending, as well as from past rate cuts, underpins the ECB's relative optimism. Although industrial orders picked up sharply in December, short-term data in general fails to capture any appreciable acceleration in, for example, Germany's growth. The latest regional bank lending survey was a bit disappointing, with demand for credit still lukewarm. But with a 15% savings rate and overall healthy balance sheets, eurozone consumers have plenty of firepower should they regain confidence.

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